VZCZCXYZ0021
PP RUEHWEB

DE RUEHCV #0475/01 0951335
ZNY CCCCC ZZH
P 041335Z APR 08
FM AMEMBASSY CARACAS
TO RUEHC/SECSTATE WASHDC PRIORITY 0910
INFO RUEHBO/AMEMBASSY BOGOTA 7740
RUEHLP/AMEMBASSY LA PAZ APR LIMA 0988
RUEHQT/AMEMBASSY QUITO 2803
RHEHNSC/NSC WASHDC
RUMIAAA/HQ USSOUTHCOM MIAMI FL
RUCPDOC/DEPT OF COMMERCE
RUEATRS/DEPT OF TREASURY

C O N F I D E N T I A L CARACAS 000475

SIPDIS

SIPDIS

HQ SOUTHCOM ALSO FOR POLAD
TREASURY FOR MMALLOY
NSC FOR JSHRIER
COMMERCE FOR 4431/MAC/WH/MCAMERON

E.O. 12958: DECL: 03/22/2018
TAGS: ECON EFIN VE
SUBJECT: BRV DEBT: MANAGEABLE LEVELS, PUZZLING STRATEGY

REF: A. CARACACS 376

¶B. CARACAS 276
¶C. CARACAS 190
¶D. CARACAS 68
¶E. 2007 CARACAS 2228
¶F. 2007 CARACAS 2207
¶G. 2007 CARACAS 2186
¶H. 2007 CARACAS 2084
¶I. 2007 CARACAS 2040
¶J. 2007 CARACAS 930
¶K. 2007 CARACAS 741
¶L. 2007 CARACAS 448

Classified By: Acting Economic Counselor Shawn Flatt for reasons 1.4 (b) and (d).

¶1. (SBU) Summary: At first glance, the BRV's sovereign debt, which totals about 19 percent of GDP when converting between bolivars (Bs) and dollars at the official exchange rate, seems low relative to other middle-income countries. A closer look suggests a slightly less rosy picture, although overall levels are still very manageable, especially given high oil prices. There are several puzzling or problematic aspects to the BRV's overall debt strategy, however, including the spike in PDVSA debt during a year of record oil revenues, the use of sovereign debt issuances to bring down the parallel rate, and the high level of bank deposits maintained by the BRV at interest rates lower than its debt coupons. Conversations with emerging market debt analysts suggest continued and in some cases growing wariness about BRV and especially PDVSA debt, which may make expected upcoming debt issuances even more expensive for the BRV. End summary.

Sovereign Debt: Manageable Levels

¶2. (U) According to the Ministry of People's Power for Finance (MPPF), the BRV had USD 27 billion in external debt and Bs 36 billion in internal debt (or USD 17 billion at the official exchange rate) at year-end 2007, levels essentially unchanged from year-end 2006. (Note: See paragraph 13 for current maturation schedules and ref J for post's summary and analysis of the debt picture at year-end 2006. End note.) Given GDP of USD 230 billion in 2007 (using local economists'

nominal GDP estimates, converted at the official rate), the BRV's external debt to GDP ratio stood at 12 percent, and its overall debt to GDP ratio at 19 percent. These figures compare favorably to regional peers such as Colombia and Argentina, whose external debt to GDP ratios are 16 and 25 percent respectively.

¶3. (U) Yet statistics are seldom straightforward in the BRV, and the debt-to-GDP ratio is no exception. The official exchange rate of 2.15 Bs/USD is clearly overvalued (ref H). Taking a more realistic rate of 3.5 Bs/USD (slightly below the current parallel exchange rate), the ratios change to 16 percent (external debt to GDP) and 22 percent (total debt to GDP). These levels are still very manageable, especially in light of current oil prices. The external debt stock is smaller than Venezuela's reserves and the equivalent of only 40 percent of Venezuela's exports in 2007 as reported by the Central Bank (BCV). (Note: The BCV's figures for exports are likely overstated (ref E); 50 percent is a more realistic figure for the ratio of external debt stock to 2007 exports. Some contacts have also questioned the BCV's stated reserves, noting that the BCV has stopped publishing their exact composition. End note.)

Adding in PDVSA: A Troubling Jump in 2007

¶4. (U) While not guaranteed by the sovereign, the debt of PDVSA, which is fully owned by the BRV, played an important role in BRV financing in 2007. PDVSA's outstanding debt stock stood at USD 16 billion at year-end 2007, an astounding increase of more than USD 13 billion from year-end 2006. New debt assumed by PDVSA in 2007 included USD 7.5 billion in bonds; a USD 3.5 billion loan from a bank consortium led by the Japan Bank for International Cooperation (JBIC); a USD 1.1 billion line of credit from a bank consortium led by BNP Paribas (renewed in early 2008); and a USD 1 billion loan taken out by CITGO to use in Venezuela. As with BRV sovereign debt, PDVSA's debt stock is certainly manageable from the perspective of its revenue stream and assets. As many commentators have pointed out, however, it is troubling that PDVSA would assume so much new debt in a year of record oil prices. Without this financing, PDVSA could not have made the same high fiscal and quasi-fiscal contributions to the BRV; indeed, PDVSA reportedly spent USD 13 billion in 2007 (i.e., the equivalent amount to the new debt it assumed) on quasi-fiscal contributions including social programs and transfers to the national development bank Fonden (ref B).

Puzzling Debt Management Strategies

¶5. (U) Despite the manageable overall levels, several aspects of the BRV's debt management practices are either puzzling or problematic. First, as suggested above, prudent counter-cyclical fiscal policy would dictate that the BRV and PDVSA pay off debt during boom times. Second, the BRV and PDVSA have both been contracting debt either payable in or guaranteed by future oil production. For example, in November 2007 the BRV and China signed a deal whereby China would provide a USD 4 billion loan to be repaid in fuel oil (ref F). (Note: President Chavez said in February that Venezuela had received the money, which implies the loan should appear in first quarter 2008 BRV debt statistics. End note.) A second example is the above-mentioned JBIC-led loan to PDVSA, which essentially functions as project finance tied to future supply contracts (ref L). In addition to putting a claim on future oil production (and thus PDVSA's revenue), deals of this type may not prove as efficient as more conventional debt mechanisms.

¶6. (SBU) A final puzzle is that many of the BRV's debt management practices simply do not seem designed to maximize revenue for the BRV. In late 2007, for example, the BRV issued USD 3.2 billion in sovereign debt in an auction system of questionable transparency that did not bring the greatest

possible returns (ref G). The BRV took payment in bolivars for the dollar-denominated portion of this issuance as part of its strategy to control the parallel rate and thereby inflation (ref A). Yet at year-end 2007, the BRV had approximately Bs 28 billion (USD 13 billion at the official rate) in deposits in the banking sector that earn lower returns than the yield on BRV debt. In other words, it is as if the BRV is borrowing money to invest it in a way guaranteed to lose money relative to the cost of borrowing. (Note: This practice is a boon for the recipient banks, which can invest the BRV's deposits in BRV bonds for a guaranteed return. End note.) In addition to their cost, the actual impact of these issuances on inflation is questionable as the bolivars received by the BRV are not taken out of the money supply (as is the case when the central bank sells securities in an open market operation).

Outlook for 2008: Oil Prices to the Rescue?

¶7. (SBU) The 2008 financing needs for the BRV, and for PDVSA, are not clear. The BRV has capital payments of approximately USD 2.2 billion and Bs 9 billion (USD 4.2 billion at the official rate) due in 2008 for external and internal debt respectively, as well as total interest payments of approximately USD 3 billion and Bs 4 billion (USD 1.8 billion) respectively. The government has the authority to issue up to Bs 16 billion (USD 7.4 billion) in new debt. However the 2008 budget as passed by the National Assembly is not a reliable guide to what the BRV will actually spend or take in (ref I; for example, the budget assumes oil prices of USD 35 per barrel). PDVSA does not publish a budget, and its finances are opaque (ref B). If it were to execute the USD 15 billion investment program it has announced for 2008 and maintain high levels of fiscal and quasi-fiscal support for the government, however, PDVSA would probably need additional financing.

¶8. (SBU) Along with the level of spending, the key determinant of financing needs for both the BRV and PDVSA is the price of oil. Should the average year-to-date price for Venezuelan oil hold throughout 2008 at USD 89 per barrel (its average from January to March 2008, as compared to USD 65 for 2007), a back-of-the-envelope calculation suggests that PDVSA would bring in an additional USD 16.5 billion in revenues. This windfall, of course, would reduce the BRV's and PDVSA's financing needs.

-- ---------

Issuing New Debt: An Expensive Proposition for the BRV

-- ---------

¶9. (C) Issuing debt is expensive for the BRV and PDVSA. As of April 2, yields on BRV and PDVSA bonds maturing in 2027 were 9.83 and 10.48 percent respectively, and Venezuela's EMBI rating (a measure of country risk that indicates the difference between yields on a country's sovereign debt and comparable U.S. T-bills) was at 619 basis point, the highest of any major Latin American economy and almost double the average for Latin America. Conversations post has had with international fund managers and analysts passing through Caracas suggest growing doubts about holding BRV debt. While noting that many managers were comfortable holding BRV debt at the current risk premium given high oil prices, one analyst said that he would nevertheless recommend that his fund reduce its holdings of BRV debt by half given political uncertainty and opacity in BRV data and accounts. Analysts have told us that international markets are "saturated" with PDVSA debt for similar reasons, and that PDVSA would have to accept an even worse yield if it issued new bonds on international markets.

¶10. (SBU) The BRV appears aware of the higher cost of issuing debt. Despite rumors, there have been no major debt issuances announced in 2008. Press reports have indicated that the MPPF is planning an April placement but that Minister Isea is continuing to evaluate his options given the

high cost and the flexibility afforded by record oil prices. Isea publicly confirmed on April 2 that the MPPF was planning an April placement, part of which would consist of dollar-denominated bonds payable in bolivars. Isea said that these bonds would be offered to importers, presumably as part of the BRV strategy of trying to control inflation by controlling the parallel rate. The increasing wariness of international fund managers toward Venezuelan debt implies that this tactic (i.e., issuing dollar-denominated bonds payable in bolivars to control the parallel rate) is not sustainable, as the Venezuelan companies and individuals who buy the bonds will have a harder time selling them on the international secondary market. (In other words, they will get increasingly fewer dollars in return for the bolivars with which they bought the bonds, thus putting upward pressure on the parallel rate.)

¶11. (C) The renewal of the BNP Paribas-led loan mentioned in paragraph 4 illustrates PDVSA's challenges and tactics for obtaining new financing. A representative of one of the major banks involved in the deal told econoff that the composition of the consortium had changed from 2007 to 2008, with U.S. banks backing out and local and Asian banks (specifically Chinese and Indian) picking up the slack. The representative opined that the BRV was probably "twisting the arms" of the local banks, which he said put up 25 percent of the total amount, and he noted that the Asian banks probably participated more in the hopes of attracting "ancillary business" than on the merits of the deal itself. Representatives of two major banks that opted not to participate told econoffs that the terms simply were not attractive enough, particularly given the opacity of PDVSA's finances.

Comment

¶12. (C) The manageable level of sovereign debt is another indication that the BRV does not face any immediate problems in its fiscal or external position (ref D), although continued reliance on PDVSA to fund quasi-fiscal spending will present increasing problems for PDVSA in the medium term (depending on the price of oil). As for the aspects of the BRV's debt management strategy that are puzzling at first blush, Chavez' political calculations and, secondly, corruption likely explain the puzzle. Especially after the paralyzing national strike of 2002-2003, Chavez appears to have felt the need to build up sizeable liquid assets, even if doing so meant issuing debt at a higher yield than the assets returned. In some specific cases, the BRV chose to support a political agenda rather than maximize revenues, as when it allocated the major 2007 PDVSA bond issuance according to size of order received (ref K). In other cases, such as the allocation methodology used for the fall 2007 BRV sovereign debt issuances, the sales of "structured notes" (see ref C), and, most recently, a reported issue of Electricidad de Caracas shares (see the Devil's Excrement blog posting for April 2, 2008, at http://blogs.salon.com/0001330/), the best explanation for the mechanisms chosen by the BRV is corruption. End comment.

Amortization Profile

¶13. (U) The table below provides the capital amortization profiles for BRV and PDVSA debt provided by the MPPF and PDVSA, in USD billions (with Bs converted at the official rate).

Year	BRV External	BRV Internal	PDVSA
2008	2.2	4.2	2.9
2009	0.7	2.3	0.5
2010	2.2	0.9	0.4
2011	2.3	0.9	0.4
2012	0.6	0.6	1.1

Beyond	19.3	7.6	10.7
Total	27.3	16.5	16.0

DUDDY